SWEETENER USERS ASSOCIATION

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Submission of the

SWEETENER USERS ASSOCIATION

To the

U.S. INTERNATIONAL TRADE COMMISSION

Pursuant to

INVESTIGATION NO. 332-325

THE ECONOMIC EFFECTS OF SIGNIFICANT U.S. IMPORT RESTRAINTS: FIFTH UPDATE

July 13, 2006

The Sweetener Users Association (SUA) appreciates the opportunity to provide information and perspective to the U.S. International Trade Commission on significant barriers to imports. SUA's members use sugar and other nutritive sweeteners in their business operations. Our membership includes confectioners, beverage companies, food manufacturers, bakers, dairy product manufacturers, cereal makers and other companies, along with the trade associations that represent these firms.

Focus of Comments

SUA's comments will focus on the tariff-rate quotas (TRQs) for raw sugar, refined sugar and certain sugar-containing products (SCPs). Historically, the raw sugar TRQ has been by far the largest and most economically significant of these restraints. However, non-quota SCP imports have grown rapidly in recent years as the persistent gap between U.S. and world sugar prices has created incentives to import products or manufacture them offshore. In the past year, the refined sugar TRQ has become increasingly important (and larger) as the U.S. Department of Agriculture sought to offset the temporary loss of a major U.S. cane refinery after Hurricane Katrina.

Needs of Users

Users of sugar need a reliable, ample supply of high-quality sugar to make the broad range of products which they manufacture. We need access to imports because the United States does not produce enough sugar to meet all market needs. However, it is definitely in users' interest to have access to domestic supplies of sugar. A viable, economically healthy sugar producing sector in the United States is important to sugar users. Geographically diverse production of both sugar beets and sugarcane is the best way to ensure supply adequacy, since unforeseen weather events – from hurricanes to drought – can have a major regional impact on sugar output. Since healthy sugarcane production is desirable and imports of additional raw sugar from other countries are necessary, it follows that users' interests are well served by an independent, viable cane refining industry.

Thus, SUA is not opposed to policies that provide economic support to sugar producers. However, present U.S. policies are poorly designed and distort markets to the long-term detriment of the entire sugar industry. A re-thinking of U.S. sugar policy is long overdue, and the 2007 Congressional farm bill debate will afford an opportunity to improve these policies.

Among present U.S. sugar policies, the TRQ is of course highly relevant to the Commission's present investigation. Our comments will focus on the TRQ rather than on other elements of sugar policy, such as price supports and marketing controls. The Commission should understand, however, that all elements of current sugar policy are closely related. All are in need of reform.

Basic Structure of the TRQ

As the Commission is aware, the United States is obliged to permit the import of certain quantities of sugar, under the terms of the Uruguay Round agreement. In particular, the minimum quota for raw sugar is 1,117,195 metric tons, raw value, while the minimum quota for refined sugar is 22,000 metric tons, raw value. ("Raw value" is a way of comparing different forms of sugar in the same units of measurement. It takes approximately 1.07 tons of raw sugar to make one ton of refined sugar because of normal refining losses, so 22,000 metric tons, raw value, is equivalent to 20,561 metric tons of refined sugar.)

The Secretary of Agriculture announces the amount of the sugar TRQs, while the Office of the U.S. Trade Representatives allocates the quotas among eligible countries. In the case of raw sugar, 40 countries have shares of the TRQ, and these are based on the countries' exports to the United States during 1975-1981, a period when U.S. trade was relatively unrestricted. (The current sugar quota regime dates from the early 1980s and was converted from an absolute quota to a TRQ in the early 1990s.)

Any TRQ creates quota rents, and the method of administering the TRQ influences who collects the rents. In the case of the raw sugar TRQ, USDA gives the governments of quota-holding

countries "certificates of quota eligibility" (CQEs) which must accompany the actual shipments of quota sugar. In this system, quota rents will generally be captured by quota-holding countries, and the selling price for quota sugar will normally correspond to the U.S. domestic price, not the lower world price.

Welfare Losses and the Sugar TRQ

Most or all independent analyses of the U.S. sugar TRQ have concluded that it constitutes a net cost to society. Essentially, these analyses compare the price of sugar in the protected U.S. market to either the world price or, in more sophisticated analyses, an estimate of the world price in the absence of U.S. import barriers. The resulting price gap is the basis for quantifying the costs of U.S. sugar policies (as well as their benefits to U.S. producers).

A potential limitation of such analyses is that they generally cannot quantify the benefits – to industrial users, final consumers and others – of a stable and reliable domestically produced supply of sugar. That such benefits exist is strongly suggested by the experience of markets when domestic supplies are disrupted, as was the case in the last quarter of 2005. Neither, however, can price-gap analyses easily quantify the costs and disadvantages of the cumbersome, anachronistic and inefficient way the current TRQ system is constructed and administered.

The existing analyses generally deal with a market situation in which there is a large gap between U.S. and world prices. Certainly that has been the rule rather than the exception in recent decades. From 1990-2005, the world price of raw sugar as reported by USDA averaged 10.05 cents per pound, and the U.S. price of raw sugar averaged 21.56 cents per pound.

However, in late 2005 and 2006, the world price of sugar has rallied strongly, closing part of the gap with U.S. prices. The world price rally has been only partly the result of transient factors (weather problems in Australia and Thailand, for instance). Rather, it has been fueled in large part by factors that may be secular rather than cyclical: the incentives to devote a greater portion of the sugarcane crop to ethanol production, especially in Brazil, because of rising petroleum prices; and far-ranging changes in European Union sugar policy that will radically reduce or even eliminate that bloc's large net export position in world sugar trade (i.e., EU sugar exports are expected to be reduced by 4-5 million tons annually as a result of the EU's sugar regime reform).

If one supposed that world sugar prices would stay near 18 cents per pound – the high in the recent market rally – and that U.S. prices would return to more normal levels as production and supplies rebounded, there would be little remaining gap between U.S. and world prices. Quoted world sugar futures prices need to be adjusted upward by about 1.5 cents per pound to account for the transportation costs necessary to equate the futures prices (deliverable offshore) to a U.S. location. This means that a world sugar price of 18 cents is about equal to a U.S. raw cane sugar price of 19.5 cents. In fact, over a long period of time, U.S. raw prices have averaged closer to 21.5 cents, but that would still mean a gap of only 2 cents – far less than the long-term gap.

Experience with volatile commodity markets suggests that it is always dangerous to project market circumstances indefinitely into the future. Nevertheless, most observers would probably expect the U.S.-world price gap to be narrower in the years ahead.

The resulting smaller economic cost estimates for the TRQ do not mean that the TRQ has suddenly become a better (or worse) policy instrument. Indeed, the traditional price-gap analysis fails to address some costs of current U.S. sugar import policies. These costs are more difficult to quantify but are real, and SUA will spend most of the remainder of this brief discussing them. Thus, even if the Commission concluded that world sugar prices had achieved a secular higher plateau – a conclusion which is premature – there would still remain ample reason to question U.S. sugar import policies. SUA believes import policies must be improved, so they are more responsive to market needs.

Quotas Create Perverse Incentives

A quota system creates a powerful incentive to fit imports into those tariff classifications that do not impose high, over-quota duties. Tight markets in 2005-06 illustrate this incentive. For example, the U.S. government's efforts to expand imports of refined sugar – in response to an unprecedented and persistent wide gap between U.S. raw and refined sugar prices – have been partly frustrated by the way the Harmonized Tariff Schedules of the United States (HTSUS) define "raw sugar."

It is customary to differentiate between raw and refined sugar on the basis of polarity, a measure of purity. The HTSUS defines raw sugar as having a polarity of 99.5% or less, and the supposition is that any sugar with a higher polarity is refined sugar (although the HTSUS does not actually say this). In a normal market this definitional question might be of mostly academic interest, since the United States imports little refined sugar. In 2005-06, however, USDA has expanded refined sugar TRQs dramatically, in a completely justified effort to offset shortages of refined sugar resulting from the closure of a major cane refinery in post-hurricane Louisiana.

It happens that the 99.5% polarity break-point no longer conforms to commercial practice in the United States. Industrial users of sugar routinely require a polarity of 99.8% or 99.9% for the sugar they purchase. It also happens that Mexico produces large quantities of a sugar – called "estandar" – which is midway in polarity between the legal break-point of 99.5% and the normal commercial standard of 99.8%. As a consequence, estandar sugar from Mexico can enter under refined sugar TRQs – and does, notably because it enjoys an advantage over offshore supply sources as a result of its proximity to U.S. ports – and yet does not immediately add to the liquidity of the U.S. refined sugar market, since it requires further refining before being acceptable to most U.S. industrial users.

It is easy to object that this problem is a consequence of the HTSUS definition of refined sugar, not the TRQ system *per se*. That may be, but the fact is that the TRQ creates the incentive to fill the quota, and Mexican estandar does so – legally, but in a manner that frustrates the intent of the USDA policy makers who expanded the refined TRQ for the purpose of importing more refined sugar, not importing raw sugar by another name.

This perverse result would be unlikely in a market where TRQs were not the policy tool of choice. There would be no race by importers to fill quotas in order to capture quota rents. Importers who wanted refined sugar of a particular polarity would obtain it as best they could from sources around the world; they would not find their options limited by imports of lower-polarity sugar, which probably would not occur in the first place.

Hence, the Commission's analysis of U.S import barriers needs to take account of the efficiency losses that result from import patterns reflecting, not the efficient allocation of available supplies, but the race to fill quotas with any product that meets government-administered quota specifications, whether it meets the needs of the private-sector end user or not.

Every Quota Creates the Incentive to Avoid It

Though intended to protect the U.S. market, sugar TRQs may have contributed to eroding the U.S. demand base for domestic sugar. Recent years have witnessed an unmistakable trend toward greater net imports of sugar-containing products – goods with high sugar content that could be manufactured in the United States, but instead are imported under tariff lines that are not subject to quotas. These SCP imports are made with world-priced sugar and thus constitute a form of "quota arbitrage" – they are attractive precisely because they can readily compete with U.S.-made goods that incorporate the higher input costs of domestic (quota-protected) sugar. Such products are both exported from and imported into the United States, and as recently as the early 1990s, exports outweighed imports. That is no longer the case, and the transition to a net trade deficit in these products has coincided with a period in which world sugar prices have been low for a sustained period, both in absolute terms and in comparison to U.S. prices.

Depending on the number of tariff lines one considers, net imports of sugar in SCPs for 2005-2006 may reach 867,000 short tons, raw value, according to statistics compiled by Promar International. Actual net imports through 2004-2005 and the resulting trendline are shown in *Chart 1.* (The U.S. Department of Agriculture achieves similar directional results with data that comprise fewer tariff lines.)

Indeed, the sugar in net imports of SCPs now constitutes around 8% of domestic deliveries. A quota system that creates incentives to erode the U.S. demand base to this extent can only with difficulty be characterized as "protection." With this sort of protection, the U.S. market has no need of threats.

It is often objected that this phenomenon – which no one denies – reflects a quest for low labor costs, not cheaper sugar. It would be naïve to suppose that labor costs are not taken into account in business decisions. Nevertheless, the available evidence suggests that sugar costs are a major factor.

Consider employment. From 1997 to 2004 (*see Table 1)*, total employment in U.S. food and beverage industries fell 2.4%, from over 1.60 million jobs to about 1.57 million. But that overall decline masked a vastly different performance in those food segments that use sugar, compared to those which do not.

Sugar-using industries – from confectioners and breakfast cereal makers to syrup and concentrate manufacturers – saw a sharp decline in employment of 9.8%. However, in those parts of the food industry that do not use much sugar – from flour milling and seafood products to vegetable fats and oils and coffee companies – total employment grew 4% over the 1997-2004 period.

So the supposed quest for cheap labor did not prevent non-sugar-using industries from *adding* American workers at the same time that sugar-using industries were *reducing* employment by nearly one-tenth. It appears that something other than labor costs was driving the very different results in these industry sectors. The U.S. Department of Commerce concluded in a recent study that sugar costs were probably a major factor, and SUA believes this conclusion is justified.

Effect of the TRQ on U.S. Cane Refining Industry

Over the past quarter-century, the U.S. cane refining industry has contracted substantially. Many refineries have closed, and thousands of unionized jobs in urban areas have been destroyed as a result.

Traditionally, U.S. cane refineries relied on both domestic and imported supplies of raw cane sugar. As U.S. production of beet sugar increased, the federal government's primary means of aligning supply with demand was the TRQ. In the absence (until recently) of supply controls on domestic cane or beet sugar, the main policy lever was the import quota: It could be reduced, and was, in order to prevent a price-depressing surplus.

The resulting reduction in raw cane sugar imports, however, had long-term consequences for the cane refining sector. It is unlikely that government sugar policies were the only factor in that industry's decline, but the fact is that in the face of rising beet sugar production, independent cane refining entered a long-term downturn at the same time as import quotas were trending downward. Other things being equal, lower raw cane sugar imports mean less throughput in the cane refining sector, so that the sector's capacity was less efficiently utilized. Not only has industry capacity declined as a result, but refining has increasingly become dominated by sugar cane producing firms. Only two non-integrated, independent cane refiners (one of which is quite small) remain in operation today.

Country Quotas are Increasingly Anachronistic

The U.S. raw sugar TRQ is allocated among some 40 countries. Consistent with the requirements of the General Agreement on Tariffs and Trade that import quotas be assigned on the basis of a "previous representative period," the quota allocations are based on market shares of the countries during 1975-1981, when sugar trade was largely unrestricted. Such an allocation undoubtedly made sense in the early-to-mid 1980s, when U.S. sugar policies took their present form.

However, it is much less clear that the current allocations are rational in the first decade of the 21st century, almost 25 years after the quota scheme was created. In that period, world production and trade patterns have shifted considerably, while quota-holding countries' shares of the U.S. market have remained largely unchanged.

The result is that some countries eligible to export quota sugar to the United States are, themselves, net importers – meaning they import sugar from the world market to satisfy domestic needs, in order to earn foreign exchange by shipping their domestically-produced sugar to the more lucrative U.S. market. This is hardly a model of economic efficiency.

Other countries apparently have production costs so high that even the prospect of gaining the internal U.S. market price is an insufficient incentive – they routinely fail to ship their quotas, exacerbating the normal shortfall in filling the entire U.S. TRQ.

Quota Shortfalls Reduce Market Access

Traditionally, a small percentage of the raw sugar TRQ has gone unfilled. In most years, the shortfall has been only around 50,000 tons out of the more than 1.1 million ton minimum TRQ. This year, however, the shortfall will be much higher – 240,000 tons, according to USDA. The high shortfall is largely a function of the unique market conditions of 2005-2006, and the increasingly complex dynamics of Mexican imports. In the latter case, the over-quota (or "second-tier") tariff on imports from Mexico is now low enough that significant quantities of sugar have entered outside the quota. Meanwhile, although Mexico has a substantial NAFTA quota this year, it has gone mostly unfilled so far, for reasons that are not completely understood.

Whatever the reason for shortfalls, they reduce the value of the overall TRQ to sugar refiners and users. In part, shortfalls reflect the outdated TRQ allocation system, which is based on market shares during a period beginning more than 30 years ago. Some countries, particularly those with small quotas, regularly fail to fill them.

The system for reassigning TRQs from one country to another is cumbersome, time-consuming, opaque and fraught with foreign policy pitfalls – and is therefore seldom used. Despite a 2002 Congressional exhortation to reallocate unused quota in a timely fashion, that has not always happened (USTR has made significant reallocations in 2005-2006). It seems clear that a better system is needed. Some degree of tradability in quotas among countries, for instance, would be a means of ensuring the entry of sugar to the U.S. market while also providing a mechanism to ensure that quota rents were captured by the original quota-holding country. Since defenders of the U.S. sugar program have frequently described the TRQ as a form of foreign aid, they should welcome such an innovation.

Future Trade Policy Realities Threaten the Current TRQ

Sugar program supporters' denunciations of the small quantities of sugar in the Central America Free Trade Agreement especially rang hollow in late 2005 as the U.S. sugar market shifted rapidly from surplus to shortage. However, future trade obligations of the United States are likely to make it difficult or impossible to operate the present sugar TRQ in conjunction with today's price support system.

No final agreement has been reached in the current Doha Development Round of World Trade Organization negotiations, but history strongly suggests that the round will eventually conclude (every previous one has), and that Congress will affirm the result (again, the invariable result in prior years). Doha Round agreements to date strongly suggest that the U.S. sugar minimum TRQ will expand, probably by several hundred thousand metric tons. It also seems likely that the over-quota tariff on U.S. sugar will have to decline.

The combination of a TRQ expansion and a cut in the over-quota tariff could well render the U.S. TRQ largely meaningless, especially if world sugar prices remain strong. In the opposite case where the TRQ maintains its significance – which would imply that the U.S. market retains a premium to the world market and is therefore an attractive destination, making the TRQ a limiting factor on total import quantities – it is not clear how long the game can last. If one posits any significant expansion in the U.S. TRQ, along with the lackluster growth in U.S. demand that has been the rule in recent years, then it seems likely that continuing present policies would doom the U.S. domestic industry to an ever-smaller capacity-utilization rate, leading eventually to the failure of some firms and their consolidation into stronger hands.

Nor is that all. Even before a Doha Round agreement could be fully implemented, Mexico will gain unrestricted access to the U.S. market. Although this will occur on January 1, 2008, the year-and-a-half between now and then will not be so different: Already, the tariff on over-quota (or "Tier 2") Mexican sugar is low enough -- about 3 cents per pound -- that such imports will constitute a significant share of U.S. supplies this year.

Can present U.S. sugar import policies adapt themselves to an unrestricted flow of Mexican sugar? In a tight market like the current one, perhaps. But shortages have been the exception rather than the rule in the U.S. sugar market for decades. The norm is more likely to be an oversupplied market. In that case, the free flow of Mexican sugar would exacerbate existing surpluses, with the result that U.S. marketing controls would be either waived – resulting in large government takeovers of surplus sugar at significant taxpayer cost – or made even more restrictive, so that U.S. producers would be trapped in the unenviable position of holding a declining share of their own market. Neither alternative is attractive, and both suggest the need to explore alternative policies.

From the standpoint of TRQ administration, the prospect of unlimited but uncertain imports from Mexico makes USDA's job more difficult. The Department is known to have low confidence in the quality of supply-demand estimates available from Mexico, yet it will need to use precisely such estimates in determining each year's TRQ. It is our hope that Mexico will improve the quality and transparency of its market data in the near future as we move to free trade in sugar in 2008.

Conclusion

The United States needs a modern, market-based and efficient sugar policy. In many ways, the present TRQ falls short of those criteria. That need not imply the abandonment of the TRQ structure completely, but could also suggest the potential for significant improvements in the way it is administered.

For purposes of the Commission's present investigation, SUA urges a thorough study of not only the price gap maintained by the TRQ, which may not even be its most onerous feature. Instead, SUA encourages the Commission to identify the inefficiencies, distortions and perverse incentives that are inherent in the current TRQ structure, and assess the adverse impacts that import quotas are having on employment in food and beverage manufacturing. In so doing, the Commission will perform a notable service to Congress, the sugar industry and the public.

SUA thanks the Commission for the opportunity to express these views.

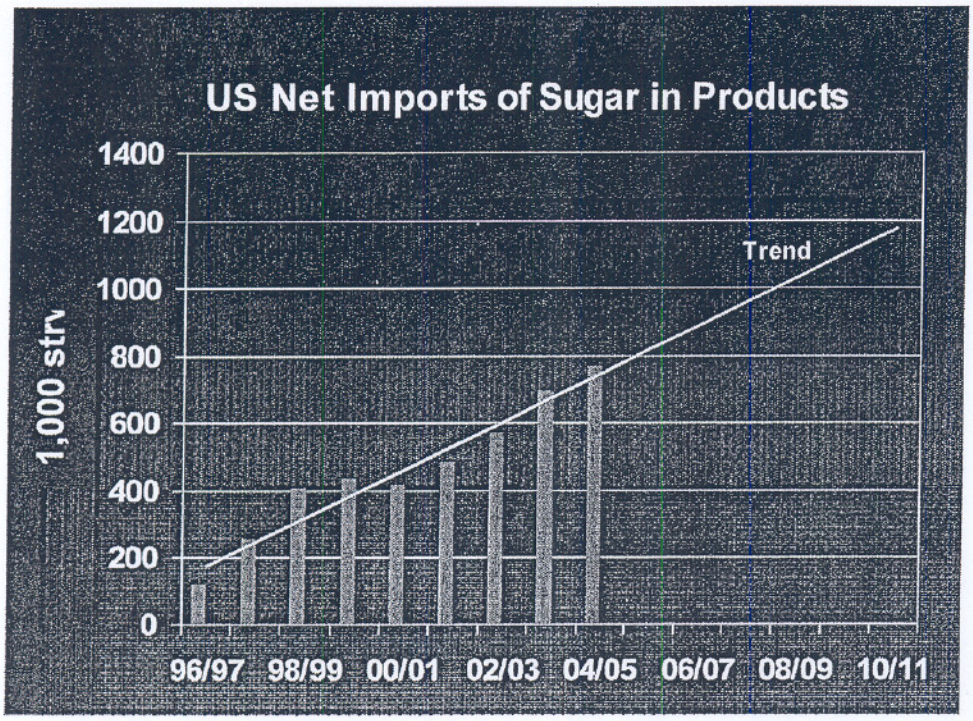
Table 1

Employment in U.S. Food & Beverage Industries

Industry	1997	2004	Absolute Change	Percent Change
Sugar-using industries				
Breakfast cereal mfg	14,396	12,294	**-2,102**	-14.6
Choc.& confec. mfg from cacao beans	9,946	8,308	**-1,638**	-16.5
Confec. mfg from purchased choc.	32,871	28,041	**-4,830**	-14.7
Nonchocolate confectionery mfg.	25,512	19,740	**-5,772**	-22.6
Frozen food mfg.	94,192	83,546	**-10,646**	-11.3
Fruit & veg canning, pickling, & drying	97,384	80,554	**-16,830**	-17.3
Ice cream & frozen dessert mfg	19,786	17,799	**-1,987**	-10.0
Bread & bakery product mfg	222,596	225,430	2,834	1.3
Cookie, cracker & pasta mfg	64,401	49,397	**-15,004**	-23.3
Snack food mfg	46,609	45,827	**-782**	-1.7
Flavoring syrup & concentrate mfg	6,243	5,482	**-761**	-12.2
Soft drink & ice mfg	83,256	70,247	**-13,009**	-15.6
Sub-total	717,192	646,665	**-70,527**	**-9.8**
Other food and beverage				
Animal food mfg.	46,651	43,339	**-3,312**	-7.1
Flour milling & malt mfg	17,877	15,071	**-2,806**	-15.7
Starch & veg fats & oils mfg	26,970	24,421	**-2,549**	-9.5
Dairy product (except frozen) mfg	112,082	107,802	**-4,280**	-3.8
Animal slaughtering & processing	464,991	493,376	28,385	6.1
Seafood product prep & packaging	40,763	38,804	**-1,959**	-4.8
Tortilla mfg	11,303	11,988	685	6.1
Coffee & tea mfg	12,895	11,163	**-1,732**	-13.4
Seasoning & dressing mfg	26,055	29,931	3,876	14.9
All other food mfg	56,886	81,951	25,065	44.1
Breweries	34,251	24,471	**-9,780**	-28.6
Wineries	18,193	23,163	4,970	27.3
Distilleries	6,417	5,085	**-1,332**	-20.8
Sub-total	875,334	910,565	35,231	**4.0**
Sugar manufacturing				
Sugar manufacturing	16,547	13,864	-2,683	-16.2
Total food & beverage	**1,609,073**	**1,571,094**	**-37,979**	**-2.4**

Source: Department of Commerce, Annual Survey of Manufactures
Compiled by Promar International

Chart 1


US Net Imports of Sugar in Products
1,000 strv
1400
1200
1000
800
600
400
200
0
Trend
96/97
98/99
00/01
02/03
04/05
06/07
08/09
10/11